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AN ANALYSIS
R. J. REYNOLDS
TOBACCO COMPANY

E. F. HUTTON & COMPANY
SIXTY ONE BROADWAY · NEW YORK

R. J. REYNOLDS TOBACCO CO.

The release of the Annual Report of R. J. Reynolds Tobacco Company provides an opportunity to review the company's progress and analyze the factors affecting its future.

While many corporations are unable to show any profits, and when all but a selected few favored companies are measuring their progress by the smallness of their earnings decline, R. J. Reynolds registers its eleventh consecutive earnings peak, the strongest financial position in its history and is earning and maintaining dividends at the highest level since its formation. Reynolds has set a standard for earnings stability against which other so-called depression-proof companies may compare their progress. Moreover, a careful analysis of the conditions influencing R. J. Reynolds in the present and past depressions reveal that highly favorable profits should be continuea, even though business recovery is postponed for another year or two. Not only is R. J. Reynolds Class "B" stock attractive as a premier depression-proof investment, but, also, as a leader in an industry which has a bright outlook for further substantial expansion. A close study of fundamental factors affecting the growth of the cigarette industry indicates that the present consumption of cigarettes is not more than one-half of the consumption which can be ultimately expected.

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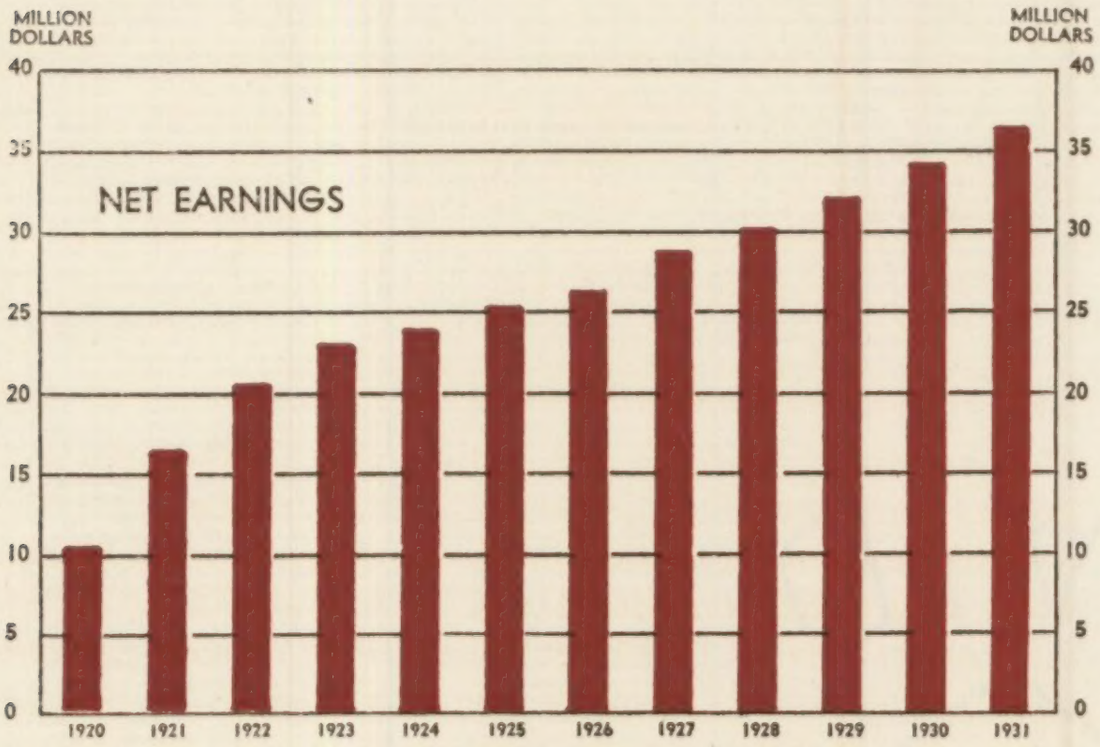
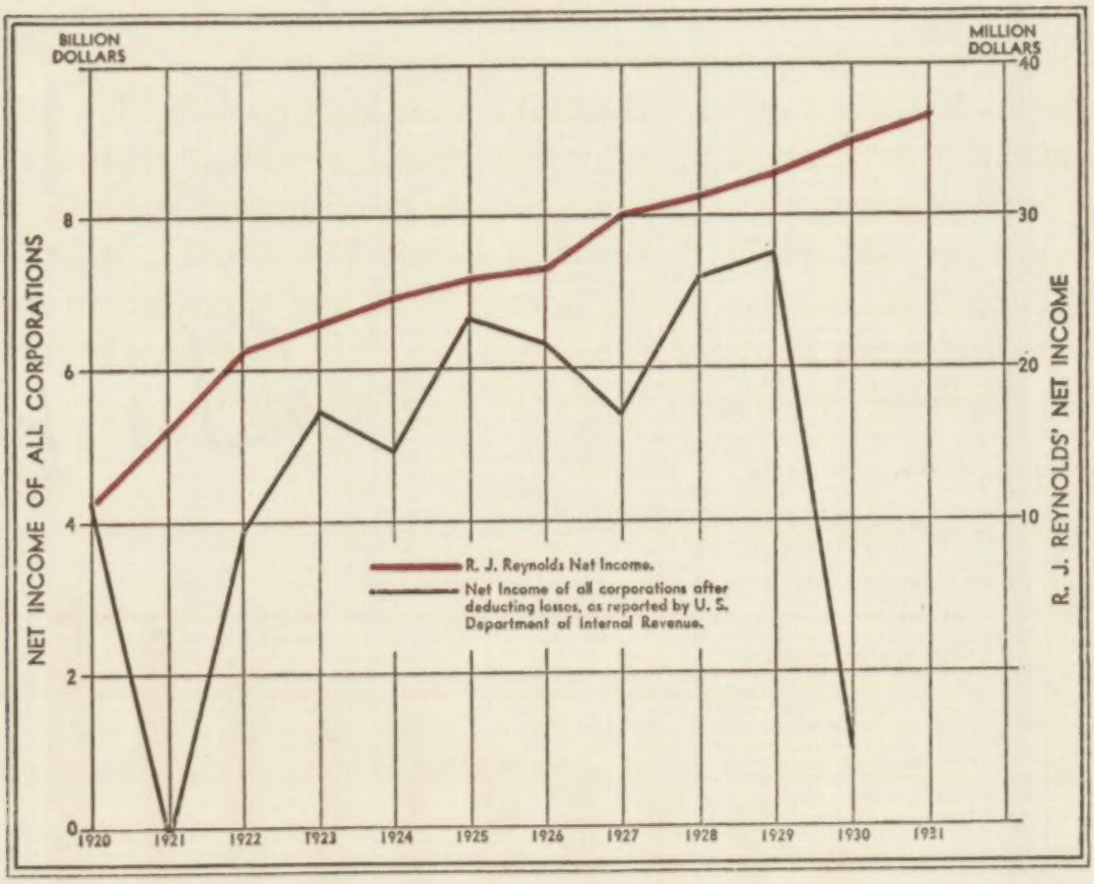
A STANDARD FOR EARNINGS STABILITY

For the eleventh consecutive year, profits of R. J. Reynolds Tobacco Company have reached a new high record. This consistent growth, through major depressions as well as prosperity, clearly entitles the stock to a high rank among investment equities. Last year R. J. Reynolds earned $36,396,817, or $3.64 per share, an increase of 6¼% over 1930, and almost three and one-half times 1920 net of $10,691,294. The consistent growth of Reynolds' earnings is shown in the chart below:

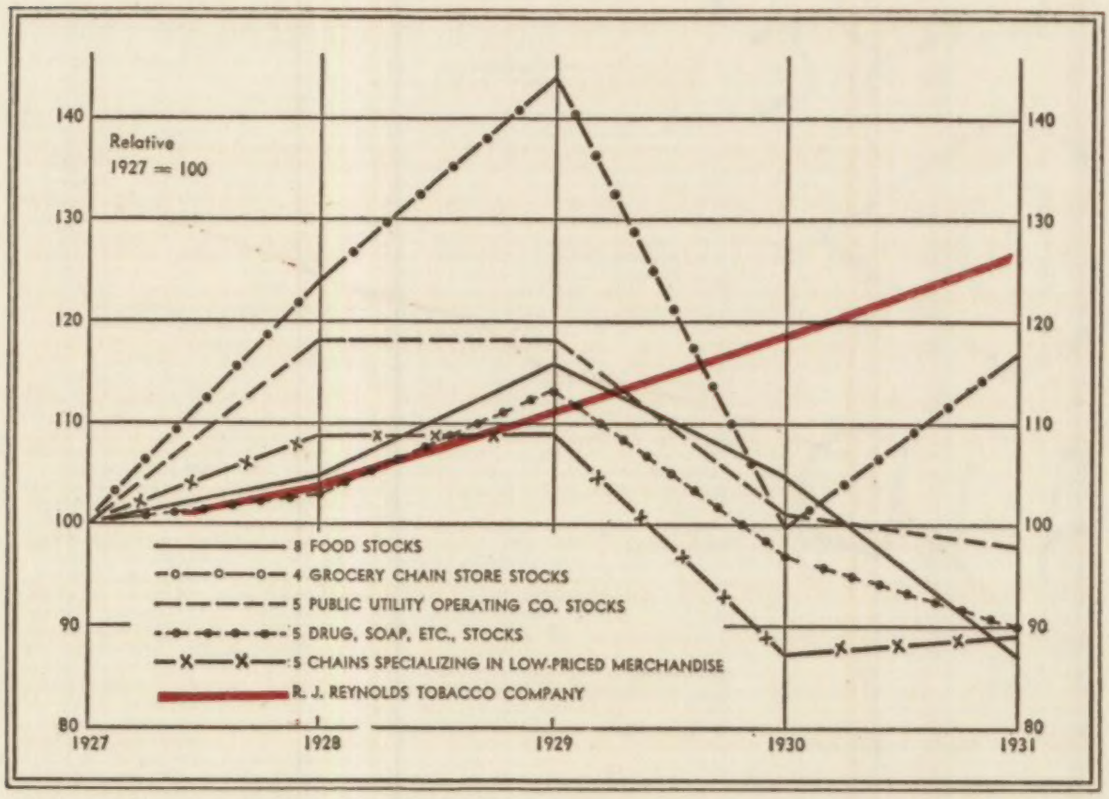


A comparison of R. J. Reynolds' net income with the aggregate net income of all corporations making income tax returns to the United States Department of Internal Revenue reveals a striking contrast. Reynolds' record of increased earnings in the depression year 1921 and new peaks each year thereafter through the prosperity of 1929 is impressive, yet far more significant is the fact that the Company successfully met the severe test of the past two years by setting new high records in each of these years,

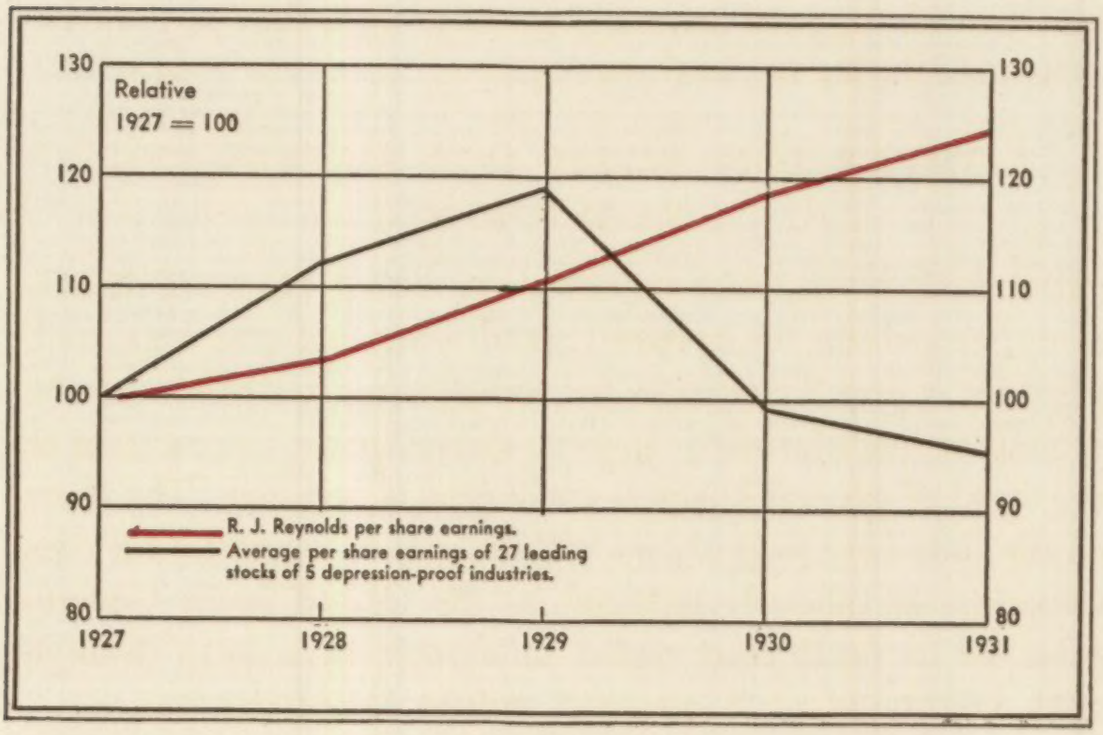
while the aggregate net income of all corporations diminished rapidly, as shown in the chart below:



More convincing evidence of R. J. Reynolds' qualifications as a leading depression-proof investment is illustrated by a comparison with the common stocks of important companies in industries which are generally considered to be the least affected by declining business activity. In the first chart on the following page we show a comparison of Reynolds' per share earnings for the past five years with the average per share earnings of (1) four large grocery chain stores; (2) five leading chain stores which specialize in low-priced merchandise; (3) eight large food and food products companies; (4) five leading drug, soap and household necessities companies and (5) five large public utility operating companies, all listed on the New York Stock Exchange. The second chart shows a comparison of Reynolds with the combined average per share earnings of 27 important companies in the five depression-proof industries used in the first chart.



Per share earnings adjusted for stock dividends, etc., and estimates for 1931 where results have not been reported, as compiled by Standard Statistics Company for the individual companies.

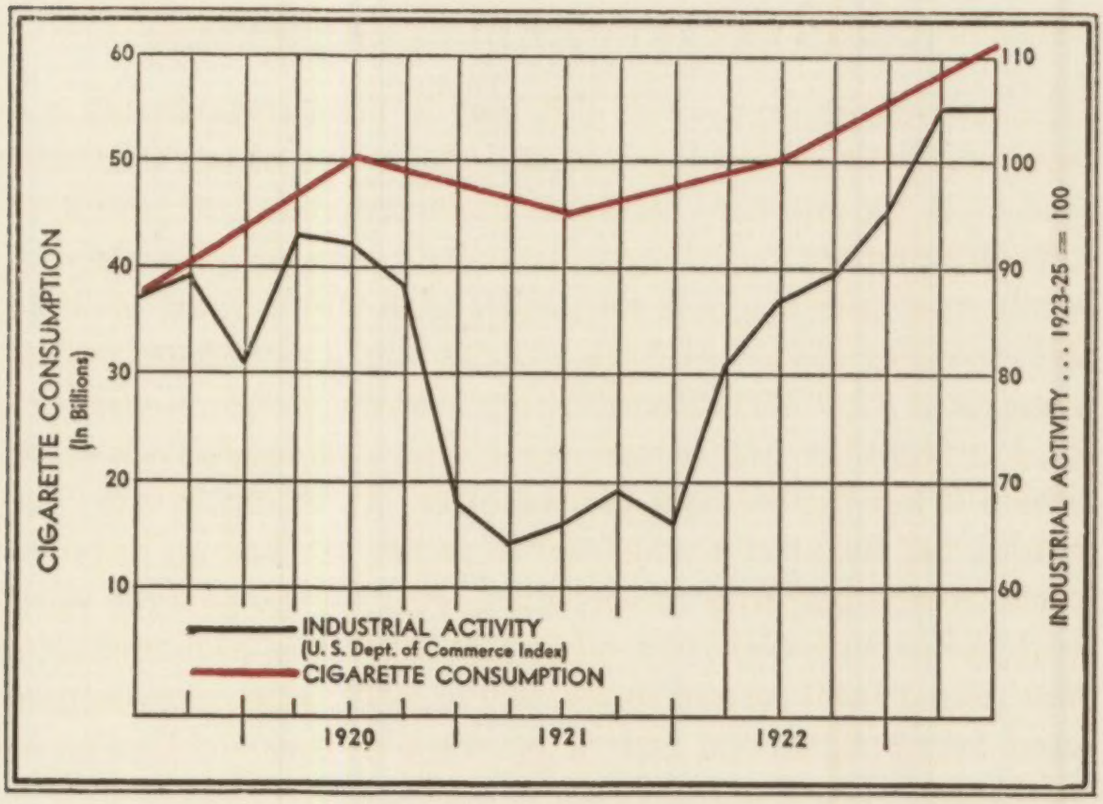


FURTHER FAVORABLE EARNINGS INDICATED

With this depression over two years old, and economy the vogue and topic of conversation, it is not surprising that consumption of manufactured cigarettes declined slightly in the last few months of 1931. The sale of manufactured cigarettes as an index of smoking, however, is misleading if considered alone. Coincident with the decline in cigarette consumption, sales of smoking tobacco increased. Thus, it is clearly indicated that the rank and file of smokers is not diminishing because of economic conditions, but merely that some of them are shifting from the convenient manufactured article to "roll-your-own" and other forms which are less expensive. As far as Reynolds is concerned, however, a decline in manufactured cigarette consumption should tend to shift at least a portion of such revenue into its smoking tobacco division. It is generally conceded that Reynolds, with its principal smoking tobacco brand, "Prince Albert," is the leader in that field. This stabilizing factor, together with lower costs for materials and supplies, coincident with declines for all commodities, and economies which the Reynolds management has effected, suggests favorable earnings regardless of the business trend during the next year or two.

COMPARISON WITH 1921 DEPRESSION REASSURING

An analysis of cigarette consumption during the 1921 depression, particularly the reversed trend when business improved, provides a firm foundation for anticipating a renewal of the growth of manufactured cigarette consumption just as soon as the trend of general business conditions is reversed. The chart on the following page shows withdrawals of cigarettes for consumption, as officially reported by the United States Government for its fiscal years ended June 30th, from 1919 through 1923, and the trend of industrial activity during that period.



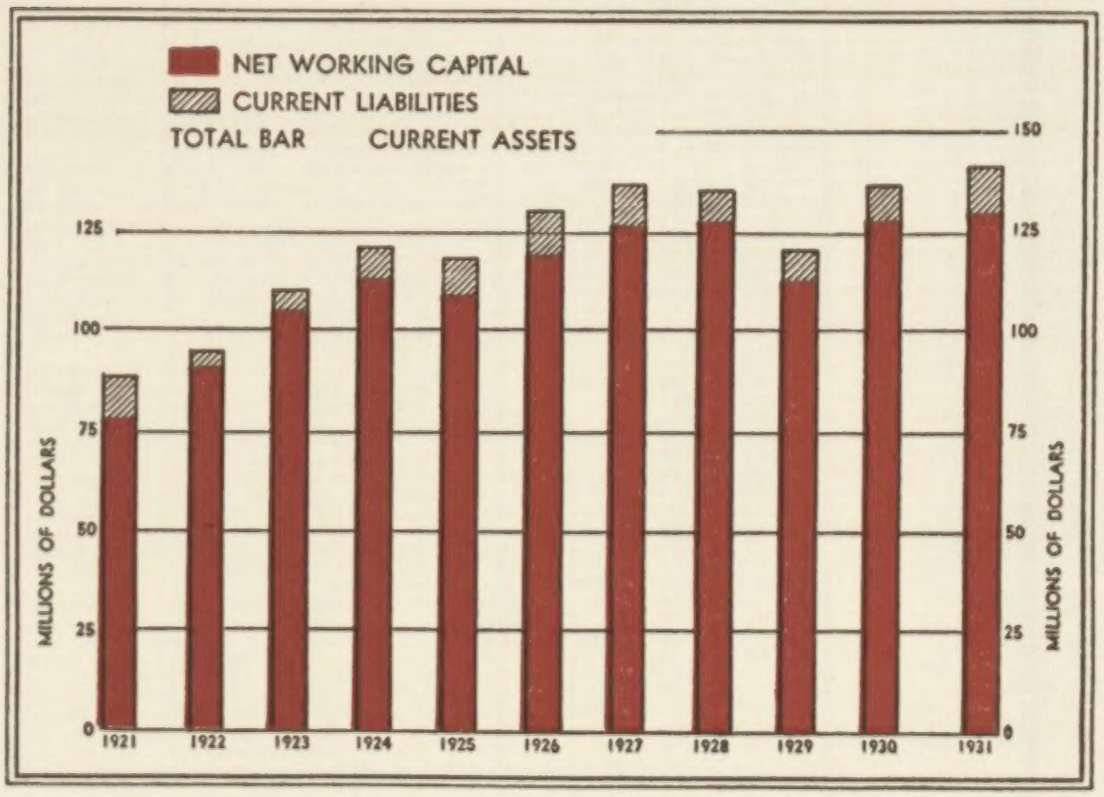
It seems obvious, therefore, that with a return of general business conditions to a more normal state, and with a reversal of the present abnormal psychology, those smokers who have turned to "rolling-their-own" will quickly spend a few cents more for the convenience and pleasure of the superior manufactured cigarettes.

FINANCIAL POLICIES

ENVIABLE FINANCIAL POSITION

The financial strength of R. J. Reynolds Tobacco Company is as satisfactory as its earnings record. At the end of last year, cash and U. S. Government securities alone amounted to over $44,000,000, or more than three and one-half times current liabilities, while total current assets were more than eleven times all debt. Net working capital of $128,242,251 was a new high, and an increase of $2,404,335 over the previous year, despite an increase of $3,958,140 in the investment in the company's own stock, which is not carried as a current asset. As shown in the chart below, the financial strength of Reynolds showed an improvement in each year over the preceding year for the past ten years, with the exception of 1925, when $20,000,000 of preferred stock was retired from current funds, and in 1929, when the company used over $18,000,000 cash to purchase its own stock as an investment.

The absence of sharp variations in earnings throughout Reynolds' recent history and the policy of maintaining the company always



in a strong financial position are a reflection of conservative management. The treatment of profits derived from the sale of part of the company's investment in its own stock is illustrative of the conservative accounting policies. These profits were not included in the income account, but were used to write down the cost price of its investment. Under the company's policy of handling this investment it held the shares of its own stock at a figure which is less than the market price at December 31, 1931.

The progressively larger earnings from 1920 through 1931, and the improved balance sheet position have been accomplished without mergers or acquisitions, and without the addition of any new capital. Furthermore, Reynolds not only financed its expansion entirely from earnings, but also retired $20,000,000 of preferred stock in 1925, and increased common dividends from $3,600,000 in 1920 to $30,000,000 in 1931.

DIVIDEND POLICY LIBERAL AND SOUND

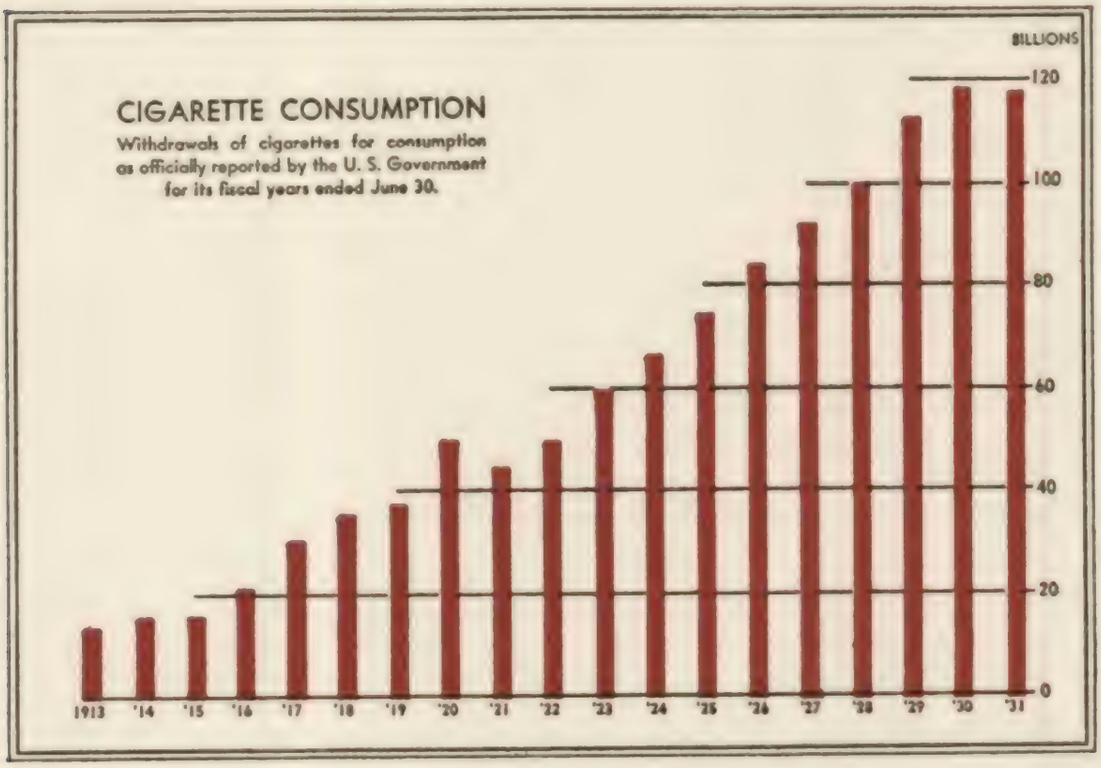
With no funded debt or preferred stock ahead of the 1,000,000 common and 9,000,000 Class "B" common shares, all profits accrue for the benefit of the stockholders. In the past the conservative management invested surplus earnings wisely, and with the present plant efficiency and strong financial position, it is no longer necessary to retain any substantial proportion of net income in the business. Stockholders, therefore, may expect liberal treatment.

OUTLOOK PROMISING

The consensus of the most competent opinions available indicates that the present consumption of cigarettes is not more than one-half of the ultimate consumption which can conservatively be expected. This contemplated increase appears almost inevitable when proper weight is given to the fact that: (1) the purchase of other forms of tobacco is more limited to the middle aged and older generations than was the case before the widespread acceptance of cigarettes. Consequently, as younger generations of cigarette smokers replace these older ones, an increasingly large proportion of tobacco consumption appears certain to be in the more profitable cigarette field; (2) the normal increase in population; (3) the rapidly disappearing sex bias in the use of tobacco. A further factor not generally conceded its important influence on the future is the continually rising proportion of adults to the total population, as revealed in population studies of leading life insurance companies. This, of course, will make available a larger proportion of the total population as potential cigarette smokers.

On the basis of facts disclosed in a thorough analysis of the tobacco industry, published early in 1930, Moody's Investors Service estimated cigarette consumption of 200 billion annually in ten years, and in an analysis published in July 1931, Standard Statistics Company estimated consumption of 145 billion in 1935.

At this point, then, when the cigarette industry has come only about one-half way to the apparent saturation point, it is not surprising that its present activities and future prospects transcend the limitations to which most industries are subject. The growth of cigarette consumption since 1913, while impressive at first glance, is really no more than would be expected for a commodity which was practically non-existent a generation ago, and is today of such importance that its distribution warrants sales outlets at every cross road. The projection into future years of past increases of about six or seven billion a year, as shown in



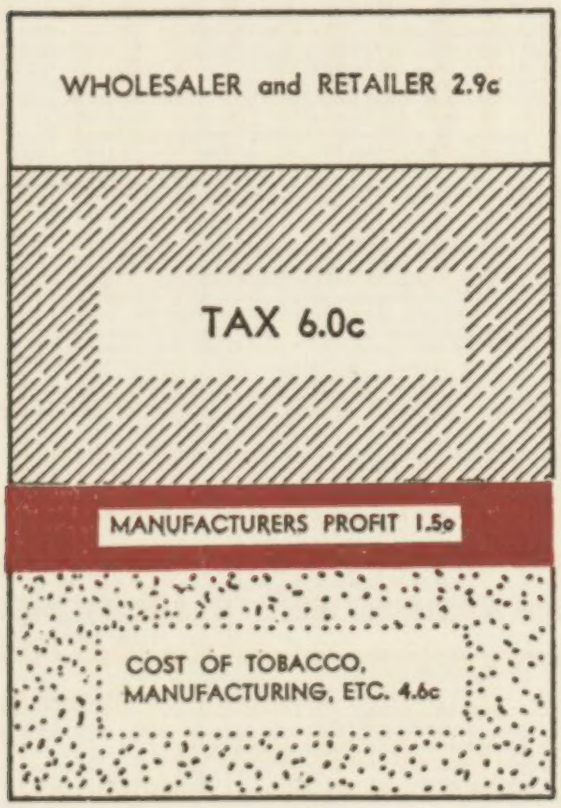
the chart above, would offer a conservative forecast of cigarette consumption for the next decade.

Any industry which has attained the size of the cigarette industry today has in the course of its development encountered and successfully overcome many obstacles which, at the time, may have caused investors to miss favorable opportunities for investment when really fundamental factors augured well for the future. A review of the history of cigarette expansion and the obstacles the industry has surmounted in attaining prominence is most reassuring for anticipating further substantial growth.

CIGARETTE TAX INCREASE UNLIKELY

The Federal tax on cigarettes is one of the few sales taxes increased or adopted during the world war which has not been decreased or eliminated. The present tax seems out of all reasonable proportion, and another increase appears too unjust for enactment. The present tax is $3 per thousand, or 6c per package.

A laborer with income from wages of only about $1,000 per year who smokes a package of cigarettes a day, pays to the Federal Government, indirectly, as much in a year as a non-smoking married man with no children, who receives a salary of over $5,000 per year. The inequitable proportion of the retail price for cigarettes which goes to the government, and the approximate distribution of the remainder, as estimated by a representative of the Tobacco Merchants Association in a recent appearance before the House Committee on Ways and Means, is shown in the accompanying chart.



Regardless of the outcome of this political and economic problem, a review of the history of price changes in the cigarette industry and their effect on the volume of sales is indicative of expansion regardless of reasonable price changes.

In 1914 a popular-priced cigarette sold for $3.90 per thousand wholesale, including sales tax, and only about sixteen and a half billion cigarettes were sold in the United States that year. In 1922, the wholesale price averaged about $7 per thousand, but consumption had increased to over fifty billion cigarettes annually. In 1930, the wholesale price was $6.40 per thousand, and consumption reached a new peak of almost one hundred and twenty billion. The 1930 sales record, an increase of more than 625% over 1914, was made in spite of a price increase of 64% over that of 1914.

When proper weight is given to the underlying factors affecting the longer term growth of cigarette consumption, and the proven ability of the industry to surmount temporary obstacles, the outlook for R. J. Reynolds Tobacco Company, in our opinion, is logically bright.

RECOMMENDED AS A DEPRESSION-PROOF INVESTMENT WITH WELL-DEFINED OUTLOOK

After experiences with theories of the "New Era" prosperity of a few years ago, investors, more today than in many years, are seeking companies with management conservative beyond any doubt, with financial condition strong beyond any question, and with no clouds on the earning outlook to cast doubt on the maintenance of dividends, even with a continuation of the depression. Not only does R. J. Reynolds Tobacco Company meet these conditions, but, also, it has its bright outlook for further substantial expansion when business conditions return to a more normal level. R. J. Reynolds Tobacco Class "B" common is currently selling at about 35 to afford a liberal return of over 8½% on the regular and assured dividend of $3.

It is an investment medium that merits consideration by those seeking safe employment of capital funds, secured income and well-defined prospects for further growth.

Statistical Department

E. F. HUTTON & COMPANY

February 8, 1932

We cannot be responsible for opinions. Information, while carefully compiled, is not guaranteed.

E. F. HUTTON & CO.

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